In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 723

F. & D. RENTALS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner purchased the operating assets of the South Bend Toy Manufacturing Co. for $300,000 less than their book value as shown on the seller's books. The purchase agreement provided that if the parties were unable to agree on the proper allocation among the assets of the $300,000 reduction in book value, the question would be submitted to a neutral arbitrator. The final contract allocated the entire $300,000 reduction in book value to fixed assets, with no part of the reduction being applied to inventory. The individual representing the seller testified that the seller had no financial interest in this allocation. On its 1958 tax return petitioner (1) used the seller's book values as

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the cost of its opening inventories in computing its cost of goods sold and (2) used the seller's book values less $300,000 as the cost basis of its land and depreciable assets in computing depreciation.

The Commissioner determined that petitioner had not correctly allocated the purchase price to the assets purchased in accordance with their relative values. Accordingly, he made his own allocation which resulted in a reduction of the cost basis of petitioner's opening inventory and an increase in the cost basis of its fixed assets. This change in the allocation resulted in a tax deficiency, since it reduced petitioner's cost of goods sold by a greater amount than it increased its depreciation. (R. 140–157.)[1] The Tax Court sustained the Commissioner (R. 139–160), and the court of appeals affirmed (Pet. 17–27).

Both lower courts agreed (1) that a lump sum purchase price should be allocated among the assets purchased in proportion to the relative values of each item purchased,[2] and (2) that the Commissioner is not required to accept an allocation specified in a contract of sale where that allocation is unrealistic and does not reflect the assets' actual values.[3] (Pet. 25–26; R. 153–

[1] "R." references are to the appendix to petitioner's brief in the court of appeals.

[2] See, *e.g.*, *Kunz* v. *Commissioner*, 333 F. 2d 556 (C.A. 6), affirming *per curiam* the decision of November 21, 1962. (P-H Memo T.C., par. 62, 276); *Copperhead Coal Co.* v. *Commissioner*, 272 F. 2d 45 (C.A. 6); *Hamlin's Trust* v. *Commissioner*, 209 F. 2d 761 (C.A. 10).

[3] See, *e.g.*, *Kunz* v. *Commissioner*, *supra*; *Copperhead Coal Co.* v. *Commissioner*, *supra*; *Majestic Securities Corp.* v. *Commissioner*, 120 F. 2d 12 (C.A. 8).

154.) Petitioner does not contest these two well-established propositions of law but argues only that the Tax Court failed to give proper regard to its evidence of the assets' fair market value. Thus, the instant case involves primarily a factual question which both lower courts decided in favor of the Commissioner.

The decision below is correct. Petitioner failed to prove the fair market value of the purchased inventory. As the court of appeals stated (Pet. 26):

> It is clear that in this case, there was no evidence of the fair market values of the *inventory* F & D purchased. In the past, the Tax Court has followed the rule that allocation of a lump-sum payment among various assets should be based upon the relative values of each item to the value of the whole. *C. D. Johnson Lumber Corp., supra* [12 T.C. 348]. Since there was no evidence of fair market value for inventory, this rule could not be followed in the instant case, nor could the Commissioner be required to follow it.
>
> The Commissioner evidently made his allocation by applying that percentage of the $300,000 reduction to inventory that inventory bore to the total assets, and by giving a similar treatment to fixed assets. In the absence of evidence which would indicate a proper allocation, the Commissioner's allocation is as reasonable as could be expected. It is presumptively correct, and F & D had the burden of proving that it was plainly arbitrary. *Cf. Helvering* v. *Taylor,* 293 U.S. 507 (1935); *Lucas* v. *Structural Steel Co.*, 281 U.S. 264 (1930).

Petitioner's evidence on this point related generally to the existing backlog of purchase orders, the turn-over of inventory, the fact that inventory was sold in normal trade channels at normal profit margins, and the fact that the finished goods inventory was used as collateral for a loan equal to 90 percent of its book value. As both lower courts concluded, these facts did not prove the fair market value of the inventory (Pet. 26; R. 154–155). Moreover, the land and buildings could not possibly have had the minimal fair market value arbitrarily allocated to them by petitioner (R. 149, 152). Finally, the record shows that the allocation specified in the contract of sale was petitioner's unilateral determination. As the Tax Court pointed out (R. 153), the seller was concerned only with the overall price paid for the business, and not with the allocation between items. Where, as here, the taxpayer fails to prove that the contract allocation is a realistic reflection of the assets' actual values, the Commissioner need not accept it.

Furthermore, the taxpayer failed to demonstrate that the allocation made by the Commissioner was erroneous. The taxpayer has a "heavy burden of proving that the Commissioner's action was plainly arbitrary." *Lucas* v. *Structural Steel Co.*, 281 U.S. 264, 271; *Helvering* v. *Taylor*, 293 U.S. 507, 515; *Welch* v. *Helvering*, 290 U.S. 111, 115; *Brunet* v. *Houston*, 283 U.S. 223, 227–228. Here, petitioner failed to meet this burden. As the Tax Court stated (R. 157):

> We accordingly approve the Commissioner's allocation in the absence of competent evidence that it is erroneous.

The cases cited by petitioner are inapposite. Cases holding that the Commissioner's determination is not to be considered as evidence (Pet. 11–13) have no application here, for the courts below did not so treat the Commissioner's determination. Similarly, those cases where the taxpayer had introduced sufficient evidence to satisfy his burden of proof (Pet. 6–13) are not relevant to the instant case since petitioner failed to satisfy its burden. For example, in *Bryant Heater Co.* v. *Commissioner*, 231 F. 2d 938 (C.A. 6), which involved the allocation of purchase price between inventory and capital assets, the taxpayer had demonstrated in support of its allocation that both buyer and seller understood that inventories were being sold at approximately book value and that a substantial premium was being paid for the capital assets. In contrast, the petitioner in this case unilaterally allocated the $300,000 to inventory and failed to carry its burden of either proving a proper allocation on the basis of fair market value or demonstrating error in the Commissioner's allocation.

The cases cited on the unreliability of book value in determining fair market value (Pet. 13–15) are likewise not in point. The contract under which petitioner purchased the assets specifically stated that petitioner was paying "a price of $300,000.00 less than the book value of said assets" (R. 142). Thus the sole question in this case is how to apportion the $300,000 reduction in book value among the assets. Since petitioner failed to prove the assets' fair market values, or that the Commissioner's allocation was not

"as reasonable as could be expected," the lower courts, in light of the unusual contract in question, accepted the Commissioner's apportionment among the assets in proportion to their book value.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

MELVA M. GRANEY,
CAROLYN R. JUST,
Attorneys.

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